INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Constitutional provisions and statutes involved	2
Statement	3
Argument	5
Conclusion	10

CITATIONS

Cases:

Commissioner v. *Sunnen*, 333 U.S. 591	5, 6, 8
Commissioner v. *Tower*, 327 U.S. 280	8
Commissioner v. *Wilshire Holding Corp.*, 244 F. 2d 904, reversing 12 T.C.M. 277, certiorari denied, 355 U.S. 815, rehearing denied 355 U.S. 879	3
Helvering v. *Clifford*, 309 U.S. 331	8
Helvering v. *Eubank*, 311 U.S. 122	8
Helvering v. *Horst*, 311 U.S. 112	8
Harrison v. *Schaffner*, 312 U.S. 579	8
Lusthaus v. *Commissioner*, 327 U.S. 293	
Oesterreich v. *Commissioner*, 226 F. 2d 798, reversing 12 T.C.M. 277	3, 5, 6, 7
Robinson v. *Elliot*, 262 F. 2d 383	7, 8
Starr's Estate v. *Commissioner*, 274 F. 2d 294	7, 8
Wilshire Holding Corp. v. *Commissioner*, 262 F. 2d 51	7, 8

Constitution and statutes:

	Page
Internal Revenue Code of 1954 (26 U.S.C.):	
Sec. 483	2, 9
Sec. 6501	2, 8
Revenue Act of 1964, P.L. 88-272, 78 Stat. 77, Sec. 224(a)	7
Constitution of the State of California, Art. 20, § 22	9
Civil Code, West's Ann. Calif. Codes, Sec. 1916-2	9

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-454

ESTATE OF WALBURGA HEDRICK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinions of the Tax Court may be found in 23 T.C.M. 1374 and 28 T.C.M. 1223, but are not officially reported. The opinions of the court of appeals (Pet. App. 1, 4-7) are reported at 406 F. 2d 587 and 457 F. 2d 501.

JURISDICTION

The judgment of the court of appeals was entered on April 14, 1972 (Pet. App. 1), and the petition

for a rehearing was denied on June 29, 1972. The petition for a writ of certiorari was filed on September 19, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

In an earlier case involving tax year 1946, a lease on petitioner's real property was held to constitute a sales contract for purposes of the federal income tax and the payments petitioner received under that contract during 1946 were held to be installment purchase payments. In the instant case, the court below held that the installment payments for years subsequent to 1946 included both amounts amortizing the purchase price—taxable as capital gains—and interest payments accrued upon the still-outstanding balance of the purchase price—taxable as ordinary income. The issues here presented are:

1. Whether the doctrine of collateral estoppel bars the holding that part of the payments constituted interest.

2. Whether the installment payments were properly apportioned for tax purposes between interest and principal.

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

The relevant portions of Sections 453 and 483 of the Internal Revenue Code of 1954, the Constitution of the State of California, and the California Civil

Code and Code of Civil Procedure are set out at pages 6-12 of the Petition.

STATEMENT

In 1929, petitioner "leased" three parcels of real property to the Wilshire Amusement Corporation for a term of 67 years, 8 months. The "lease" agreement provided for rental payments of $7,500 per year for the first 10 years, $12,000 annually for the succeeding 18 years and progressively declining amounts over the remainder of the term. The lease provided that at the end of the "lease" term, Wilshire was entitled to acquire title to the property for an additional payment of $10. (Pet. App. 9-10.)

The income tax treatment of petitioner's receipts and the "lessee's" expenditures under this "lease" agreement came before the Court of Appeals for the Ninth Circuit in *Oesterreich* v. *Commissioner*, 226 F. 2d 798, reversing 12 T.C.M. 277, and *Commissioner* v. *Wilshire Holding Corp.*, 244 F. 2d 904, reversing 12 T.C.M. 277, certiorari denied, 355 U.S. 815, rehearing denied, 355 U.S. 879. In these cases, the "lease" agreement was held for tax purposes to constitute a contract for the sale of petitioner's property and the payments petitioner received in the tax year 1946 were consequently held to be installment purchase payments rather than rental income as initially reported. The court of appeals reasoned that the $10 option price for which Wilshire could acquire title to property which would apparently be worth over $100,000 on the option date was obviously not the actual consideration petitioner would receive for

the sale of the property, and held that the payments which the parties had characterized as rent were actually the purchase payments for the property. (Pet. App. 8-17, 19-20.)

The instant case involves payments petitioner received for years subsequent to those in issue in the earlier cases. The Commissioner of Internal Revenue determined that for those succeeding years taxes should be based upon the premise that a portion of each payment petitioner received should be attributable to interest accrued upon the total purchase price still outstanding, as in the case of an ordinary mortgage, and that the portion of the payments allocable to interest should be taxed as ordinary income. In order to allocate between interest and principal, the Commissioner used an amortization schedule based upon an 11.9 percent interest rate. The Tax Court (23 T.C.M. 1374 (1964)) upheld the deficiency determined on this basis. The court of appeals held that its earlier decision involving petitioner did not collaterally bar the Commissioner from treating the subsequent receipts partially as interest, on the ground that there had been such a change in the legal climate since the first opinion as to render the bar of collateral estoppel inoperative. The court held, however, (Pet. App. 4-7), that the Tax Court had erred in upholding the Commissioner's use of an amortization table based on such a high rate of interest, and remanded the case to the Tax Court for a redetermination of the deficiency based upon an amortization schedule bearing a lower rate of interest. On remand

(28 T.C.M. 1223), the Tax Court apportioned the petitioner's receipts between principal and interest in accordance with a seven-percent amortization schedule. The court of appeals affirmed (Pet. App. 1).

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other consideration warranting further review. Moreover, the substantive tax issue here has been resolved for the future by an amendment to the Internal Revenue Code of 1954.

1. The decision below was not collaterally barred by the Ninth Circuit's earlier decision, *Oesterreich* v. *Commissioner*, 226 F. 2d 798. (Pet. App. 8-17.) The limited scope of collateral estoppel in federal income tax cases was defined by this Court in *Commissioner* v. *Sunnen*, 333 U.S. 591. After noting that taxes are levied on an annual basis and that, therefore, a judgment on the merits for one tax year does not conclude all tax questions as to later years, the Court stated (p. 598): "* * * if * * * [a] later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit." And the sweep of collateral estoppel within even that limited area was further restricted by the Court, which noted that the doctrine of collateral estoppel was (pp. 599-600)—

> * * * designed to prevent repetitious lawsuits over matters which have once been decided and

> which have remained substantially static, factually and legally. It is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers.
>
> And so where two cases involve income taxes in different taxable years, collateral estoppel must be used with its limitations carefully in mind so as to avoid injustice. It must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged. * * * a judicial declaration intervening between the two proceedings may so change the legal atmosphere as to render the rule of collateral estoppel inapplicable.

The court in *Oesterreich* viewed (Pet. App. 11) the "sole issue" before it as whether the 1929 agreement was "a lease or a contract for the sale of land." (226 F. 2d at 801.) Having decided that the agreement was a sales contract, it concluded, without further discussion, that petitioner's 1946 receipts were taxable at capital gains rates. The instant case presents an issue not addressed by the parties in *Oesterreich*—whether the petitioner's installment receipts contain an element of interest accrued upon the sales price which should be taxed as ordinary income. Since that issue was not before the court in *Oesterreich*, it is not now foreclosed by the decision in that case. *Commissioner* v. *Sunnen*, *supra*.

Moreover, there has been a substantial change in the relevant "legal atmosphere" since the entry of the

Oesterreich decision. In *Wilshire Holding Corp.* v. *Comissioner*, 262 F. 2d 51 (C.A. 9), *Robinson* v. *Elliot*, 262 F. 2d 383 (C.A. 9), and *Starr's Estate* v. *Commissioner*, 274 F. 2d 294 (C.A. 9), lease agreements were recast as contracts of sale for tax purposes and, in each instance, payments made pursuant to these lease-sale agreements were held to constitute in part the payment of principal and in part the payment of interest accrued upon the outstanding principal. Further, in the Revenue Act of 1964, P.L. 88-272, 78 Stat. 77, Section 224(a), the Congress passed Section 483 of the Internal Revenue Code of 1954, which expresses a Congressional recognition that sales contracts with long payment periods inherently contain some element of interest. These changes in the legal atmosphere have lifted the collateral bar which petitioner would attribute to the *Oesterreich* decision.

Petitioner contends (Pet. 22-23) that since the change in the legal atmosphere did not occur until after some of the years here in issue, those early years should be taxed as though there had been no change in the operative rule from that laid down in *Oesterreich*. In other words, while not claiming a vested right in perpetuity to the tax treatment set out in the *Oesterreich* opinion, petitioner seeks to establish a vested right in that treatment until the date on which the legal atmosphere actually changed. None of the years which petitioner seeks to have taxed under the *Oesterreich* rule, however, were barred by the statute of limitations. Internal Revenue

Code of 1954, Sec. 6501. In fact, some of the years petitioner seeks to immunize from the tax treatment dictated by *Wilshire Holding Corp.* v. *Commissioner, supra, Robinson* v. *Elliot, supra,* and *Starr's Estate* v. *Commissioner, supra,* occurred well after the tax years involved in those very cases. Petitioner's proposed application of collateral estoppel thus would lead to what this Court sought to avoid in *Sunnen*—"inequities among taxpayers." [1]

2. The allocation of petitioner's receipts between principal and interest was correct. The court below approved a division between principal and interest based upon a seven-percent amortization schedule. This schedule was derived by applying an interest factor to the schedule of payments set out in the "lease" and working backwards over the term of the "lease." Each scheduled payment was first applied to interest and then to principal, in the fashion of a normal mortgage financing arrangement. The seven-percent interest rate utilized in the calculations comports with both the rate of interest the parties themselves agreed would apply to overdue payments and to the rate of interest payable on judgments under the

[1] Indeed, this Court has implicitly rejected the claim petitioner asserts here. In *Sunnen,* changes in the prevailing legal climate heralded by decisions entered in the years 1940 (*Helvering* v. *Clifford,* 309 U.S. 331; *Helvering* v. *Horst,* 311 U.S. 112; *Helvering* v. *Eubank,* 311 U.S. 122), 1941 (*Harrison* v. *Schaffner,* 312 U.S. 579), and 1946 (*Commissioner* v. *Tower,* 327 U.S. 280; *Lusthaus* v. *Commissioner,* 327 U.S. 293) were held sufficient to remove all collateral bars to the proper tax treatment of income received in 1937, a full three years prior to the change in legal climate.

applicable state law. Constitution of the State of California, Art. 20, Sec. 22.[2] The amortization schedule thus represents the most realistic allocation that could now be devised.

3. The issue here presented has been settled for the future by an amendment to the Internal Revenue Code of 1954. Under Section 483 of the Code, passed as a part of the Revenue Act of 1964, *supra*, sales contracts with deferred payment schedules must provide that deferred amounts earn interest. If the sales contract provides for less than an adequate amount of interest on the outstanding balance, additional interest will be apportioned to the parties in accordance with the system set forth in Section 483. The instant case thus does not present any issue of ongoing administrative importance. Nor can the petitioner point to any decision in conflict with the holding below. Instead, the instant case presents the last example of a judicial solution to the tax abuse inherent in the "interest-free" loan. The solution

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[2] Petitioner complains (Pet. 21) that there is compounding of interest under the amortization schedule, which it asserts is forbidden by applicable California law. California law, however, permits compounding when agreed to in writing by the party to be charged. Civ. Code, West's Ann. Calif. Codes, § 1916-2. Quite apart from the fact that petitioner, as the recipient of compounded interest, is hardly in a position to assert Wilshire's objections to that interest, the schedule of payments to which the parties agreed in writing implicitly provides for compounding. The payments for the early years were so small, and those for later years so large, that any amortization schedule providing an even rate of return over the entire term would have to provide for compounding the deficiencies in interest incurred in the early years.

reached in this case was correct and clearly permissible under the doctrine of collateral estoppel. There is no reason for further review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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